Submission by the **Digital Cooperation Organization**[1]

to the United Nations **Ad Hoc Committee** for Drafting Terms of Reference for a

United Nations Framework Convention on International Tax Cooperation

First Substantive Session – 15 March 2024

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INTRODUCTION

The Digital Cooperation Organization (DCO) welcomes the opportunity to submit input for the First Substantive Session of the Ad Hoc Committee for drafting Terms of Reference (ToR) for the United Nations Framework Convention (FC) on International Tax Cooperation. While DCO is fully convinced that international tax cooperation should be secured through the platform of the United Nations for it to be transparent, inclusive, and effective, it suggests addressing the fundamental question of allocation of taxing rights in the digitalized world in a simple way to ensure fairness and efficiency of the international tax system.

SUBMISSIONS

The submission by the DCO will cover two topics. The first one related to ToR on the procedural component of the structural framework of the FC on International Tax Cooperation. The second one is related to the substantive component of the FC.

1. Procedural Component of the Framework Convention on International Tax Cooperation

Following are submissions regarding the procedural component.

1.1. Definitions, Objectives, and Principles should be aligned with the indicative list of elements of the substantive part of the FC.

1.2. A fully-fledged secretariat is necessary for the FC.

1.3. Conference of Parties (CoP) of sovereign states should be created as a supreme decision-making body.

1.4. CoP should have the power to adopt protocols and amendments in the FC.

1.5. Each party to CoP must have a right to vote. However, the number of votes necessary for each decision may vary depending on the nature of the protocol or the amendment.

1.6. There should be at least two subsidiary bodies – one for doing necessary research on issues to assist CoP, and another subsidiary body for monitoring implementation.

1.7. There should be a commitment to meet the education and training needs of tax administrations on international taxation and ICT, especially for developing countries.

1.8. There should be a commitment to access and exchange of financial statements of MNEs.

1.9. There should be a commitment to help SMEs in developing countries adopt ICT for combating large informal sectors.

1.10. A robust and trustworthy dispute resolution mechanism should be included in the FC.

1.11. There should be a financial mechanism for meeting the FC's work costs.

2. Substantive Component of Framework Convention on International Tax Cooperation

The following are submissions regarding the indicative list of matters that could be addressed in the draft ToR for the substantive component of the FC. These matters should be highlighted in the FC as a protocol priority. These submissions, in addition to many others, suggest two Principles of the FC – First, equitable allocation of taxing rights, and second, protection of state sovereignty on tax matters.

2.1. Allocation of Taxing Rights on Simple, Equitable, and Efficient Basis

Taxing rights have traditionally been entitled in favor of developed countries because of their position as capital and technology exporters. The OECD Model Convention for Taxes on Income and on Capital as an instrument of the Bilateral Tax Convention (BTC) is visibly imbalanced. The developed countries achieve their national goal of securing the most taxing rights due to their competitive advantages of capital and technology. On the other hand, developing countries historically offer tax concessions to access capital and technology and forego their rightful taxing rights in this tax competition resulting in cross-border erosion of their tax bases.[2] Thus, a fair international tax equilibrium is needed.

The existing international rules for allocating taxing rights are based on the Principle of Origin which derives strength from the Benefits Theory, Ability to Pay Theory, etc.[3] Undoubtedly, market jurisdictions of developing countries provide benefits of access to markets and infrastructure to consume goods and therefore have some right to tax. Under the latest Value Creation Theory, economic value is created either where the goods or services are created and where these are sold and consumed.[4]

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2 Garfias von Furstenberg, G. (2021) '*Allocation of Taxing Rights in Tax Treaties between Developing and Developed Countries: Re-thinking Principles*' Doctoral Thesis, Maastricht University, Netherlands.

3 Ivan Ozai (2021), 'Origin and Differentiation in International Income Allocation' 44:1 *Dalhousie Law Journal*, p-133.

4 Ibid.

The Value Creation Theory is consistent with the accounting principle of recognition of revenue whereby income is credited in the income statement when goods or services are sold or used. These theories hold ground even for digital goods and services.

Unfortunately, most BTCs between developed and developing countries do not conform to these age-old theories. For example, the conditions of physical presence in the form of PE to tax business; and denial of taxing rights at origin for royalty income are the concessions given by developing countries to access technology.

Further, MNEs now substitute physical PEs with virtual PEs (De-facto) to sell their products through e-commerce in developing countries for their poor infrastructure and regulatory frameworks. It is evident in increasing the volume of international trade as sales by PEs are being substituted by exports by MNEs. It is untenable to hold that income does not arise in market jurisdictions merely due to the shifting of trading mechanisms to electronic modes or the increasing volume of digital goods and services. Such an interpretation of facts would deprive the developing countries of their share of taxing rights. The issue applies squarely to cross-border business services. Thus, the FC should mention fair allocation of taxing rights as a priority in its protocols.

2.2. State Sovereignty be Protected Regarding Taxation and Tax Concessions

BTC negotiations demonstrate the inherent tax competition involved in this process as each participating state aims to achieve its national goal by using its competitive advantages. Resultantly, developed countries mostly win taxing rights while developing countries get access to capital and technology by not taxing income in their jurisdictions. Besides that, poor infrastructure and weak regulatory framework have additional influence on developing countries to offer tax concessions to attract capital and technology to harness the full potential of their economic factors like natural and human resources.

In this competition involving competitive advantages and economic factors of engaging parties, there should not be any discriminatory restraints on any party. Rationally, developing countries should not be restrained from granting tax concessions to attract capital and R&D while developed countries should not be restrained from using their tech superiority to secure all taxing rights. In the given scenario, let all countries compete with their strengths within reasonable limits. Unilateral action against developing countries would leave them as mere consumer markets for developed countries, further worsening income inequality between the two and jeopardizing the world order.

A study proposes that free tax competition is essential for the efficient allocation of resources, reduction of global poverty, and equal distribution of wealth.[5]

All states are equal sovereigns under the UN charter and taxation is an inherent component of sovereign status[6]. The dissolution of sovereignty exclusively for taxation cannot be approved on the pretext of ending tax competition because tax competition is driven by several competitive advantages that states possess. If sovereignty is to be dissolved it should be dissolved for all these competitive advantages. Likewise, the OECD's demand for a centralized tax system for achieving equity in the tax system is untenable as equity in tax is relevant to the domestic realm,[7] and redistributive justice at the international level requires rationalization of other factors influencing capital allocations, and expenditure programs at the global level. If the global public interest is the central goal, then all laws and resources should be aligned with this goal. More aptly, a global community cannot be created selectively for taxation without other factors of welfare such as the sharing of technology, free flow of human resources, and distribution of wealth amassed in the hands of a few. Therefore, the FC should provide a commitment to the protection of the state sovereignty in taxation.

2.3. Allocation of Taxing Rights of Intellectual Properties (IPs) and their Scoping

First, consistent with Para 2.1. taxing rights be allocated based on economic value created in a jurisdiction. All classes of income be treated the same[8] even for allocating taxing rights. When income from immovable property is taxed in the source jurisdiction as the economic value is generated there, then, rationally royalties' income on the use of Intellectual Properties (IPs) be taxed in the jurisdiction where those are used.

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5 David Elkins, (2016), 'The Merits of Tax Competition in a Globalized Economy' 91:3 *Indiana Law Journal*, Maurer School of Law: Indiana University, p-905

6 Allison Christians, (200() '*Sovereignty, Taxation and Social Contract*' 18:1 Minnesota Journal of International Law, University of Minnesota Law School, P-104.

7 Elkins (2016) Above n, 5, p-942

8 Jason Furman, (2008), 'The Concept of Neutrality in Tax Policy' The Brookings Institution, Testimony before the U.S. Senate Committee on Finance Hearing on 'Tax: Fundamental in Advance of Reforms', USA; Lena Hiort af Ornas Leijon, (2015) '*Tax Policy, Economic Efficiency and the Principle of Neutrality from the Legal and Economic Perspective*' Working Paper 2015-2, Faculty of Law, Uppsala University, Sweden, P-23.

The intangible nature of IPs and the ease with which they can be transferred cannot refute the fact that they are used in market jurisdictions, which have contributed to the economic value and consequently are entitled to some taxing rights.

Though developing countries need IP-related technology and hence continue accepting unfair allocation of taxing rights, that would deprive them of essential revenues for sustainable development resulting in massive income disparities between developing and developed countries which might tear apart the global fabric.

Second, the overlaps between royalties, fees for technical services, and Automated Digital Services (ADS) should be resolved through scoping of IPs. It should be understood that the automation of processes and tasks through ICT-based mediums such as software and AI are not analogous to the use of processes or copyrighted and patented items because buyers do not use them. Instead, these tasks are automatically performed with simple prompts. Therefore, automation of tasks of all kinds through ICT-related interventions should be treated as services as distinct from letting out of other IPs for use by the licensee. More broadly, the distinctions between ADS, software, and other IPs need to be defined in a simple flexible manner to avoid ambiguities like one in Article 12B (7) in the UN Model Tax Convention, which envisages that the items already covered as royalties and fee for technical service will be excluded from ADS. Para 62 of the UN Commentary on its Model Tax Convention regarding Article 12B stresses some challenges here. Therefore, the FC should give priority to the fair allocation of taxing rights of IPs in its protocols.

2.4. Tax-related Illicit Financial Flows from Aggressive Tax Planning and Tax Evasion

The tax-related illicit financial flows are driven by tax evasion and aggressive tax planning. The latter is mostly addressed by the OECD BEPS project, and by the UN through the latest amendments of its model BTC. The former is related to developing countries for their large informal economies. Alongside other measures, international tax cooperation is needed in building the capacity of SMEs, which dominate informal sectors, and of tax administrations for adopting ICT technology to simplify bookkeeping, facilitate tax compliance, and strengthen tax enforcement to mobilize untapped revenue potential of informal sectors and raise tax to GDP ratio. The FC should provide a commitment for this capacity building of SMEs.